PORTFOLIO MONTHLY REPORT – September 2022

Situation

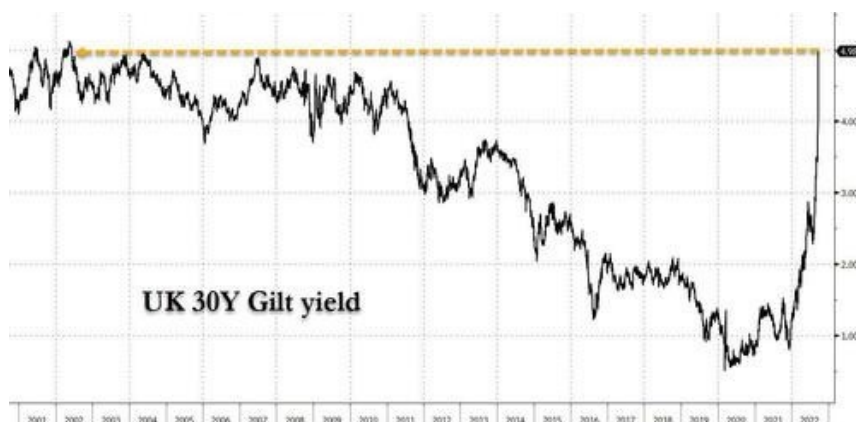
As we start the last quarter of 2022 it is interesting to look back over the year and get some perspective of what has happen. That will help us charter the remainder of the year and what we need to consider for 2023.

In a newsletter (Nov2021 published 7 Dec) I quoted the following from the ECB website: "*The staff projection foresee inflation at 1.7% in 2022 and 1.5% in 2023. We are confident that inflation will decline in the course of 2022.*" At the time I wrote that those numbers looked very optimistic and this has proved to be the case. Inflation in the Euro area for August 2022 was quoted at 9.1%. This is an error on the part of the ECB of drastic proportions and it is not a result of the war in the Ukraine.

Other central banks such as in the UK and the USA have also been completely wrong in their inflation policy, as a consequence we are now heading into inflationary times. In an attempt to restore some credibility the central banks have raised interest rates in September. The USA and the ECB by 0.75% and the Bank of England by 0.5%, but the bank rates are still well below the inflation rates. The high inflation of the 1970s (see newsletter Oct 2021) was ended by raising rates beyond the inflation rate. Doing that today, with high debt levels, would be very destructive to global economies, but the market is forcing rates higher without regard for central bankers.

The UK is having huge problems with its Government bond market (Gilts). Bonds do not like rising inflation because they have a fixed interest (or coupon) and the only way for this to rise is for the bond price to fall. Last September the 10 year UK Government Gilt was yielding 0.8%, while today it yields 4%, due to a substantial fall in the Gilt price. One of our fund managers has been shorting Gilts and year to date his fund is up + 90% (Yes, that is a ninety percent gain).

In fact the new UK government's policy of paying individual's gas and electricity bills has severely backfired. They aim to pay for this by borrowing more money, but the announcement made the ten year Gilt move from 3.5% to 4.5% in just two days. That extra 1% will cost the UK dearly. It is most clear in the 30 year Gilt exploding to over 5%. This means Gilts have fallen in price significantly in 2022.

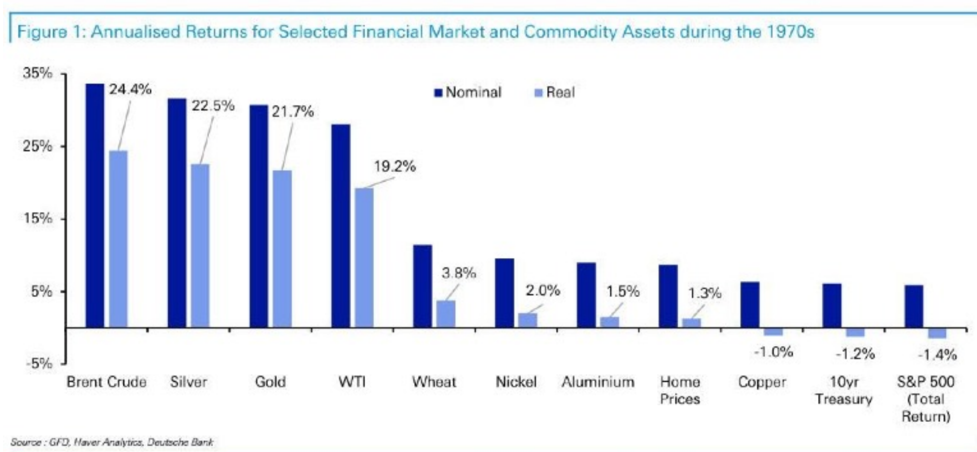


The UK plan is estimated to cost GBP 100 billion and to borrow that for 10 years the cost would be at 3%p.a. = 30 billion interest i.e. 130 billion all together. Now, at 4%, it is 140 billion! What happens in 2023 if energy prices continue higher, then more borrowing, more interest? The money does not disappear of course, it goes to the energy companies, to the gas suppliers, to the shippers to the providers, the natural gas companies coming from USA and UAE etc..

There is a limit to borrowing and the UK government is finding that out. The very latest plan this week is more QE, i.e. The Bank of England buys the debt to support Gilt prices. That means creating Pounds at the Bank of England and giving it to the Treasury for a piece of paper repayable in 10 or maybe 30 years! Sterling will suffer, imports become more expensive, inflation rises, interest rates rise, mortgage rates higher, property prices lower. (Months ago we moved sterling cash into US dollars.)

From an investment standpoint it has proved a folly to believe in the standard mantra that Government bonds are safer than shares. A leading UK Gilt fund is down -27% for the year and since many pension funds will be fully loaded with such bonds they will be in trouble. Watch out for pension funds having problems meeting their pension liabilities. (I drafted this note a week ago before this actually started to happen).

This chart was in the June/July 2022 newsletter and I think it needs to be looked at again.



The asset classes to the right hand side have been the standard allocation for the last decade, but I think that is no longer the case. Although gold is disappointing this year in US dollar terms, in GBP and Euro terms it is up year to date, while the main stock markets are significantly lower. If the US central bank stops talking about raising rates the dollar will drop compared to gold and the miners in particular will do very well.

One further point to consider for Q4 and 2023 is the war in Ukraine. Markets seem to have ignored the real threat of this developing further, with a very negative impact on Europe and the world in general. Hopefully it will end soon but we need to consider it might get worse.

Best wishes

Tim 7 October 2022